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The Insurance And Tax Consequences Of Settling FCA Cases

By **Andy Liu and Jason Lynch** (September 24, 2018, 2:21 PM EDT)

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There are two types of government contractors: those that have been accused of violating the False Claims Act and those that will be someday. In fiscal year 2017 alone, there were 799 new FCA cases filed, and the U.S. Department of Justice obtained more than $3.7 billion in settlements and judgments from civil cases involving fraud and false claims against the government.[1] This is no mere blip — over the past six years, we have seen an average of 811 new FCA cases filed and recoveries of over $4.3 billion per year. Most of this money is, not surprisingly, collected through settlement agreements. Last month alone saw an $84.5 million settlement by a hospital system in Michigan,[2] a $65 million settlement by hospitals in California[3] and a $21 million settlement by an ambulance company in Texas.[4]

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Settling an FCA case has implications beyond the bottom-line dollar figure. Two such implications are insurance and taxation.[5] When you settle a case, will you have to pay the money out of pocket, or could some or all of it be covered by insurance? Can you write off some or all of the amount from your taxes? This article provides an overview of the salient points of settling an FCA case and a high-level survey of the relevant case law.

Damages and Penalties

The statute is simple enough: A person who violates the FCA “is liable to the United States Government for a civil penalty of not less than $5,000 and not more than $10,000 [as adjusted over time] plus 3 times the amount of damages which the Government sustains because of the act of that person.”[6] Yet calculating the “damages” can prove anything but straightforward. “There is ‘no set formula for determining the government's actual damages’ for an FCA claim.”[7]

For settlement purposes, the task is made harder still. Where the plaintiff alleges 100 false claims causing $1 million in damages, and the case settles for $2 million, how much of that $2 million are “single” damages and how much are the trebled component?[8] How much of it represents the per-claim penalties that would have been imposed had there been a judgment finding the 100 claims to be false?

The answers have implications for both insurance and tax purposes.

Insurance

The obvious preference for any FCA defendant is to obtain coverage for as much of the settlement/judgment as possible. That goal usually runs headlong, however, into the several obstacles.

Exclusions for "Wrongful Acts"

These[9] are often defined to include "any act, error, omission, breach of duty, misstatement or misleading statement." In short, fraud is generally uninsurable.[10] This is a high hurdle to clear. Moreover, the issue is made more complex by the fact that the FCA also punishes conduct that does not amount to fraud. As the following cases illustrate, successfully obtaining coverage is highly dependent on interpreting the particular policy language and governing law.

To be sure, many courts have barred coverage of FCA suits. A federal district court in Illinois, applying the law of that state, held that an exclusion for claims "arising out of a dishonest, fraudulent, criminal, or malicious act or omission, or intentional misrepresentation" barred coverage of an FCA suit.[11] Applying Louisiana law, a district court in that state found that a policy exclusion for "liability ... contributed to by [the insured's] dishonesty" precluded coverage for an FCA suit (and related common-law claims brought by the DOJ).[12] Faced with an argument that the FCA requires merely "reckless disregard," and thus is not necessarily "dishonesty," a court in the Central District of California disagreed.[13] Applying Washington state law, another district court similarly held that an exclusion for "dishonest, fraudulent, criminal or intentional acts, errors or omissions committed by or at the direction of the insured," precluded coverage for an FCA suit.[14] ("Liability under the FCA involves dishonesty. ... The FCA claim falls within the dishonest act exclusion and RUSI had no duty to defend or indemnify MSO.")[15]

When it comes to "wrongful acts"-type exclusions, however, courts have distinguished between coverage for a judgment in an FCA case and the settlement of the same. After Gallup settled a qui tam lawsuit in which the DOJ intervened, it sought declaratory judgment in Delaware Superior Court that the settlement amount ($10.58 million) was insured.[16] The insurer defended on the grounds that the "claims covered by the Settlement constitute[d] either fines, penalties and multiplied damages or overpayment of money paid to Plaintiff [which] would unjustly enrich [Gallup]."[17] The insurer argued that "the terms used in a settlement agreement are irrelevant," and urged the court instead to look at the "underlying allegations."[18] Although the insurer also argued that the settlement was uninsurable as a matter of public policy — because it was, in effect, insurance for fraud — there was already a "Fraud/Ill-Gotten Gains Exclusion" in the policy, and that exclusion required "a final adjudication" on the merits. The court reasoned from this that the mere allegation of fraud/ill-gotten gains, and a no-fault settlement thereof, was contemplated by the parties to be insurable.[19] While the Gallup case turned on the language of the policy at issue, the issue is likely to recur: many policies have similar "final adjudication" provisions, and most FCA settlements admit no fault or liability.

In another case, the court denied coverage because, ironically, there wasn't a final decision on liability.[20] The International Association of Chiefs of Police settled FCA allegations for $340,000 and sued its insurer (St. Paul) for breach of contract when it denied coverage.[21] The terms of the policy required that liability be (1) "established by final court judgment," (2) "by a written agreement signed by the [insured and the insurer]," or (3) determined in writing by the insured. The IACP's settlement was none of the three, as it was not signed by St. Paul. The reason why St. Paul refused, moreover, was

because of a “dishonest acts” exclusion.[22] Because the policy only excluded dishonest acts that “a court holds were committed deliberately,” and the settlement agreement admitted no intent, the IACP argued that the exclusion was inapplicable. Avoiding that argument, the court ruled instead that the IACP received “unlawful profit” (i.e., restitution) through the alleged mischarging.[23] More on that below.

These cases illustrate the importance of a defendant’s particular insurance policy. In Gallup, the defendant got coverage because there was no final adjudication of the fraud claim. But in IACP, the insurer was able to refuse coverage precisely because there was no final court judgment. This precludes any broad statement about whether FCA judgments are insurable and requires that every analysis begin with the given policy language.

Definition of “Loss”

Many policies exclude from their definition of “loss” money that is merely returned to its rightful owner — i.e., restitution. Apart from the policy language, the applicable state may have public-policy limitations on what is an insurable loss.

In either case, FCA defendants have ample case law on their side. First, there is a fundamental difference between “restitution” and “damages.”[24] The FCA clearly provides for “damages.”[25] Second, in FCA cases specifically, courts clearly distinguish between FCA damages and restitution.[26] Defendants should be on firm footing, therefore, to argue that damages paid through an FCA settlement are not “restitution.”[27]

That is not to say that the cases are unanimous. In the IACP case above, the court reasoned that, although the settlement did not admit intentional fraud, the settlement did admit the mischarging, which constituted “unlawful profit” under the dishonest-acts exclusion. The settlement had described half of the $340,000 value as “restitution to the United States for mischarging which occurred under the grants” and the other half as “constitut[ing] damages recoverable under 31 U.S.C. Section 3729.”[28] Interestingly, the court found both to be “unlawful profit.” The court described the then-double-damages provision of the FCA not as a “penalty,” but as meant to make the government whole.[29] We explore the distinction between punitive and compensatory damages in the next section.

Exclusions for “Punitive Damages,” “Fines,” “Penalties,” etc.

These exclusions, too, may derive from the policy itself or from broader public policy in the applicable state. Whatever portion of the settlement might be attributed to the per-claim penalties in § 3729(a)(1) could obviously fall within this exclusion.[30] The damages portion is trickier: What portion of FCA damages is compensatory and what portion is punitive?

The U.S. Supreme Court has equivocated on the issue. In Cook County, Illinois v. U.S. ex rel. Chandler, the court backtracked seemingly from a position taken in an earlier case, Vermont Agency of Natural Resources v. United States ex rel. Stevens.[31] In Stevens, the court relied on the “essentially punitive” nature of the FCA’s treble damages to find that states were immune from suit.[32] But then in Cook County, the court reasoned that “the damages multiplier has compensatory traits along with the punitive” in holding that municipalities were amenable to suit.[33] This schizophrenia has left the lower courts guessing about how exactly to characterize FCA damages.[34]

The line is not necessarily drawn between the first third of the treble damages — often called ‘single’

damages — and the other two thirds. In a well-known FCA case, decided when the FCA only imposed double damages, the Supreme Court cited "the congressional judgment that double damages are necessary to compensate the Government completely for the costs, delays, and inconveniences occasioned by fraudulent claims."[35] That is a remedial, not a punitive, objective.[36]

There is also an argument that some portion of the (now treble) damages are meant to pay the relator's share of the settlement or judgment, which can be as high as 30 percent.[37] That objective is similarly nonpunitive. The upshot is that one cannot formulaically draw the compensatory/punitive line at the one-third or even two-thirds level; "the tipping point between payback and punishment defies general formulation, being dependent on the workings of a particular statute and the course of particular litigation."[38]

Finally, some insurance policies are specific enough to exclude "the multiplied portion of any damage award."[39] This could exclude coverage of those damages regardless of whether they are deemed punitive under applicable law.

The DOJ has not, historically, engaged on the foregoing questions. From the government's perspective, insurance coverage was between the defendant and its insurer. As explained below, however, recent legislation will force the DOJ to get involved.

Tax Deductibility

One component of the 2017 tax legislation was to reform the deductibility of business expenses under the Internal Revenue Code, 26 U.S.C. § 162.[40] Specifically, Section 13306 amended the deductibility of "fines and penalties" under 26 U.S.C. § 162(f). Previously, the Code prohibited deductions for "any fine or similar penalty paid to a government for the violation of any law."[41] The section now provides an elaborate "Exception for amounts constituting restitution or paid to come into compliance with law" for any amount that the taxpayer can establish either:

(1) constitutes restitution (including remediation of property) for damage or harm which was or may be caused by the violation of any law or the potential violation of any law; or

(2) is paid to come into compliance with any law which was violated or otherwise involved in the investigation or inquiry[.] (hereinafter "compliance payment").[42]

The amount must also be identified as such in the court order or settlement agreement,[43] although labeling it as restitution or a compliance payment "alone shall not be sufficient to make the establishment required under clause (i)."[44] Finally, the new law makes clear that there is no exception for "any amount paid or incurred as reimbursement to the government or entity for the costs of any investigation or litigation."[45] The upshot is that restitution may be deductible, but reimbursement of investigation/litigation costs will not be.

The IRS expects to issue regulations on the subject.[46] Importantly, however, those regulations will not delay the applicability of § 162(f).[47] Defendants and the DOJ will have to divvy up settlement amounts into "restitution," "compliance payments," and "fines/penalties" under existing law — which, as described above, is not pellucidly clear. The "transitional guidance" says nothing about how to characterize, for example, a $2 million settlement of $1 million allegations. It merely says that the identification requirement is met if the settlement agreement or judgment "states on its face that the amount is restitution, remediation, or for coming into compliance with the law."[48] But as the guidance

reiterates, merely identifying a payment as “restitution” does not make it so. The IRS has requested public and agency comments on, among other things, “how to define key terms in § 162(f).”

The law also added a new reporting requirement, codified at 26 U.S.C. § 6050X, which requires the “appropriate official”[49] at the relevant agency to report (1) the amount of the settlement/judgment that is non-deductible under the broad prohibition against fines and penalties; (2) any amount that qualifies for the exception as restitution; and (3) any amount that qualifies for the exception as a compliance payment.[50] This report (or “return”) is to be made “in such form as determined by the Secretary [of the Treasury].”[51] The same information must be provided in writing “to each person who is a party to the suit or agreement.”[52] All of this reporting has been put on hold, however, until at least Jan. 1, 2019.[53]

Once effective, the legislation will have immediate and important impact. First, it requires the DOJ to enter the fray of dissecting and labeling money paid through FCA settlements and judgments.[54] Second, the breakdown will have to be memorialized in the settlement agreement or judgment itself, which will allow the public to begin tracking the "multiples" at which the DOJ and relators are settling cases.[55] Particularly with regard to the DOJ, this might allow defendants to make more sophisticated settlement pitches, citing recent settlements on analogous facts and arguing that they should receive a similar multiplier.

Conclusion

The most obvious relationship between insurance and tax deductibility is that they work at cross purposes when it comes to characterizing settlements and judgments under the FCA. Generally speaking, defendants will want a little as possible to be deemed “restitution” when dealing with insurers, who often exclude such payments either through their policy language or under applicable state law. (They must stop short, however, of allowing the sum to be characterized as “fraud” or “dishonesty,” which are often excluded under other provisions.) But then for tax purposes, defendants will want as much of the total amount as possible to be deemed “restitution” in order to deduct it from their taxable income.

All of this is compounded by semantic ambiguities. By “restitution,” the 2017 tax law likely does not have in mind what professor Douglas Laycock does when he distinguishes between restitution and damages.[56] That is to say, it is entirely possible that the law refers by “restitution” to the single-damages portion of a treble-damages award under the FCA — or even to the full amount, on the theory that multiple damages are necessary to make the government entirely whole. The answer will depend on future IRS guidance and interpretation by the courts.

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[1] Press Release, Justice Department Recovers Over $3.7 Billion From False Claims Act Cases in Fiscal

Year 2017 (Dec. 27, 1017), https://www.justice.gov/opa/pr/justice-department-recovers-over-37-billion-false-claims-act-cases-fiscal-year-2017.

[2] Press Release, Detroit Area Hospital System to Pay $84.5 Million to Settle False Claims Act Allegations Arising From Improper Payments to Referring Physicians (Aug. 2, 2018), https://www.justice.gov/opa/pr/detroit-area-hospital-system-pay-845-million-settle-false-claims-act-allegations-arising.

[3] Press Release, Prime Healthcare Services and CEO to Pay $65 Million to Settle False Claims Act Allegations (Aug. 3, 2018), https://www.justice.gov/opa/pr/prime-healthcare-services-and-ceo-pay-65-million-settle-false-claims-act-allegations.

[4] Press Release, Ambulance Company and its Municipal Clients Agree to Pay Over $21 Million to Settle Allegations of Unlawful Kickbacks and Improper Financial Relationships (Aug. 27, 2018), https://www.justice.gov/opa/pr/ambulance-company-and-its-municipal-clients-agree-pay-over-21-million-settle-allegations.

[5] There are many others, including: suspension/debarment; the relator's role and ability to litigate proposed settlements with the government; reporting obligations; publicity; and others.

[6] 31 U.S.C. § 3729(a)(1)

[7] United States v. Anghaie, 633 F. App'x 514, 518 (11th Cir. 2015) (quoting United States v. Killough, 848 F.2d 1523, 1532 (11th Cir. 1988)).

[8] This is not simple arithmetic. The plaintiff might say that there was $1 million in single damages and that it settled for a multiplier of two, but the defendant might say that one-third of the damages could never have been proven, and that the multiplier was actually higher. Or, depending on the settlement figure, the defendant could say that none of the amount are damages.

[9] Sometimes, as in the case of management-liability policies, the covered acts are called "wrongful." Upon inspection, however, these policies envision acts that fall short of intentional wrongdoing, such as "errors," "omissions," "negligence," and "misleading statements." See Int'l Ass'n of Chiefs of Police, Inc. v. St. Paul Fire & Marine Ins. Co., 686 F. Supp. 115, 117 (D. Md. 1988). The same policy in IACP excluded coverage for "dishonest acts."

[10] Some states go even further. California, for example, bars insurers form indemnifying "anyone from fraud or from negligent misrepresentation." Cal. Ins. Code § 533 (West 2018). See generally Office Depot, Inc. v. AIG Specialty Ins. Co., No. 2:15–cv–02416–SVW–JPR, 2016 WL 6871283, at *5 (C.D. Cal. July 21, 2016) (emphasis added) (collecting cases), rev'd and remanded on other grounds, 722 F. App'x 745 (9th Cir. 2018), reh'g denied (June 25, 2018).

[11] Gen. Star Nat'l Ins. Co. v. Adams Valuation Corp., 69 F. Supp. 3d 742, 745 (N.D. Ill. 2014).

[12] XL Specialty Ins. Co. v. Bollinger Shipyards, Inc., 57 F. Supp. 3d 728, 757 (E.D. La. 2014).

[13] Los Angeles v. Nat'l Union Fire Ins. Co., No. 12-cv-07662-BRO, 2014 WL 12573322, at **8-9 (C.D. Cal. Apr. 29, 2014). Admittedly, the court in Los Angeles was deciding whether to certify interlocutory appeal, and thus only had to find that "coverage under the [insurance policy was] not an issue with a

substantial ground for disagreement.” Id. at *9 (emphasis added).

[14] MSO Washington, Inc. v. RSUI Grp., Inc., No. C12-6090-RJB, 2013 WL 1914482, at *9 (W.D. Wash. May 8, 2013).

[15] See Int’l Ass'n of Chiefs of Police, Inc. v. St. Paul Fire and Marine Ins. Co., 686 F. Supp. 115 (D. Md. 1988).

[16] See Gallup, Inc. v. Greenwich Ins. Co., No. N14C–02–136FWW, 2015 WL 1201518 (Del. Sup. Ct. Feb. 25, 2015).

[17] Id. at *4

[18] Id.

[19] Id. at *10.

[20] See Int'l Ass'n of Chiefs of Police, Inc. v. St. Paul Fire & Marine Ins. Co., 686 F. Supp. 115 (D. Md. 1988).

[21] Id. at 116.

[22] Id. at 117.

[23] Id.

[24] See In re Lehman Brothers Holdings, Inc., 855 F.3d 459, 480 n.29 (2d Cir. 2017) (citing Douglas Laycock, Restoring Restitution to the Canon, 110 Mich. L. Rev. 929, 938 (2012) (“The fundamental question in damages . . . is how much a plaintiff lost . . . . But in restitution, ... [it] is how much [the] defendant was unjustly enriched.”)).

[25] 31 U.S.C. § 3729(a)(1).

[26] See, e.g., U.S. ex rel. Taylor v. Gabelli, No. 03 CIV 8762 (PAC), 2005 WL 2978921, at *5 (S.D.N.Y. Nov. 4, 2005).

[27] But see infra § IV. (Tax Deductibility).

[28] Id. at 117 & n.1.

[29] Id.

[30] Even on that point, however, some courts have said that the penalties can serve some remedial purpose. See United States ex rel. Purcell v. MWI Corp., 15 F. Supp. 3d 18, 32 (D.D.C. 2014), rev'd and remanded on other grounds, 807 F.3d 281 (D.C. Cir. 2015) (awarding the highest possible penalties, in part, because “the Government expended a massive amount of resources to pursue this case over the years” and collecting cases for that proposition).

[31] See Cook County, Illinois v. U.S. ex rel. Chandler, 538 U.S. 119 (2003); Vermont Agency of Natural

Resources v. U.S. ex rel. Stevens, 529 U.S. 765 (2000).

[32] 529 U.S. at 784

[33] 538 U.S. at 130.

[34] See, e.g., U.S. ex rel. Drakeford v. Tuomey, 792 F.3d 364, 387-88 (4th Cir. 2015).

[35] United States v. Bornstein, 423 U.S. 303, 315 (1976).

[36] Cf. IACP, 686 F. Supp. at 117 n.1 ("Thus, although the insurance policy expressly excludes coverage of 'fines or penalties imposed by law,' it is unclear whether the doubling of the $170,000 mischarged by IACP must be considered uninsured on that basis alone.") (citing Bornstein, 423 U.S. at 314).

[37] 31 U.S.C. § 3730(d)(2). Interestingly, the relator's share was 50% under the double-damages version of the statute and was lowered to 15-30% under the treble-damages version. See Pub. L. No. 99–562, 100 Stat. 3153 (1986). Thus, the relator's share has roughly tracked the amount of the 'single' damages. But see Bornstein, 423 U.S. at 315 n.11 (finding that the argument "would have some force if the only enforcement mechanism provided in the Act were the qui tam action. However, the Act clearly envisioned that the Government could sue on its own behalf[.]").

[38] Cook County, 538 U.S. at 130.

[39] See, e.g., Gallup, Inc., 2015 WL 1201518, at *2

[40] Internal Revenue Code, 26 U.S.C. § 162 Pub. L. 115-97.

[41] Id. (2016).

[42] 26 U.S.C. § 162(f)(2)(A)(i). There is also a new, separate "exception for any amount paid or incurred by reason of any order of a court in a suit in which no government or governmental entity is a party." Id. § 162(f)(3). This raises the question whether declined qui tam suits may be excepted wholesale from the category of "fines, penalties, and other amounts." Because "certain court orders" is not elaborated upon, Congress' intent with respect to Section (f)(3) is hard to discern.

[43] Id. § 26(f)(2)(A)(ii)

[44] Id. § 26(f)(2)(A).

[45] Id. § 26(f)(2)(B).

[46] See IRS Notice 2018-23 (Mar. 27, 2018) (offering "Transitional Guidance" in the meantime).

[47] Id. § 26(f)(2)(A).

[48] This sentence prompts two additional observations. First, IRS refers to "the amount" as if the entire settlement/judgment will be either deductible or not. That seems unlikely, given the treble-damages scheme in the FCA (discussed above). Second, it is unclear how the parties in an FCA suit will force the court—in the case of a judgment—to identify the breakdown. Absent a statutory command directed to

the courts, judges may be loathe to wade into a complicated (and academic, from their point of view) debate about how much of an FCA jury's verdict is 'restitutionary' in nature.

[49] 26 U.S.C. § 6050X. "Appropriate official is later defined as "the officer or employee having control of the suit, investigation, or inquiry or the person appropriately designated for purposes of this section." Id. § 6050X(c). For FCA-settlement purposes, this will almost certainly mean the assigned civil assistant, U.S. Attorney, or DOJ trial attorney.

[50] Id . The requirement only applies to settlements or judgments of $600 or more. Id. 6050X(a)(2)(A)(ii).

[51] Id. § 6050X(a)(1).

[52] Id. § 6050X(b).

[53] IRS Notice 2018-23 at 1, 5.

[54] Since there must be an "appropriate official" in every case, presumably the assigned DOJ attorney would have to submit a "return" in every declined case, too. But see n.47, supra (querying whether declined qui tam suits are excepted wholesale). This is no small task.

[55] This term merely refers to the ratio between the alleged single damages and the total settlement amount.

[56] See Laycock, Restoring Restitution to the Canon, supra.